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ABSTRACT

The effect of the Tax Reform Act of 1986 on college and university revenues and expenditures is reviewed. Institutional revenues are derived primarily from five sources: tuition, charitable contributions, debt financing, endowment income, and governmental appropriations. The effect of the new law on family and student income, savings, student loans, and financial aid are briefly examined. The impact of the new law on the cost of charitable contributions at both the individual and corporate levels is addressed, along with implications for college fundraising strategies. Also considered is the effect of the new law on the private use of capital assets financed with tax-exempt debt. The impact of the new rules on institutional expenditures is addressed, including retirement and other employee benefits and the costs of compliance. The purpose of the Alternative Minimum Tax and calculation of this tax are covered, and the old and new tax law are compared in terms of individual and business income taxes, itemized deductions, long-term capital gains, trusts and estates, credits, tax-exempt debt, and retirement savings. (SW)

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Tax Reform and Higher Education

The core of tax reform is the reduction of tax rates and the broadening of the tax base through the elimination of many deductions, tax credits and other tax benefits. Through these and other changes the Internal Revenue Code of 1986 will substantially affect every individual and business.

Most Americans applaud the new tax law as it attempts to simplify our system of income tax collection and tries to reduce the degree to which tax incentives distort economic behavior. Higher education, along with other non-profit activities, is widely perceived as a publicly useful enterprise and was often the beneficiary of incentives which have been reduced or eliminated. As a consequence, this recounting of the effects of the Internal Revenue Code of 1986 on colleges and universities is, more often than not, a negative one. Nevertheless, the authors of **Capital Ideas** join with others in their praise of the new law and do not intend the explanation of these changes as an indictment of the legislation.

This issue of Capital Ideas will provide an overview of the new law's impact on higher education. It will explain the most significant changes in detail and will highlight other areas for further discussion. It will review the new law in the context of the law's effect on institutional revenues and expenditures.

Revenue

Institutional revenues are derived primarily from five sources. These are tuition, charitable contributions, debt financing, endowment income, and governmental appropriations.

TUITION

Tuition is paid from parental and student income, savings, student loans, and financial aid. The effect of the new law on each of these will be briefly examined below.

Family Income. The multiple bracket system with a top rate of 50 percent will be replaced by two brackets of 15 and 28 percent and an additional surtax for high-income taxpayers which eliminates the advantage of the initial 15 percent rate. The phase-in of the surtax creates, in effect, a 33 percent marginal bracket for some taxpayers. Married individuals filing jointly with incomes between $72,000 and $150,000, for example, will be subject to the 33 percent marginal tax. Still, the new tax rates will be lower and will create more disposable income, some of which may be earmarked for higher educational expenses. On the other hand the elimination of many deductions

Double Issue

Tax reform is a complicated and very important issue for institutions of higher education. Rather than splitting the discussion into two or more issues we have consolidated Vol. 1 No. 3 and Vol. 1 No. 4 into one issue to present an overview of this major legislation. Gail Franck of the Forum's staff was this newsletter's principal author.

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If a dependent student earns over $4,000, and the parents can claim her as a dependent, she is likely to pay more taxes under the new law.

Some higher education officials are trying to reintroduce all educational debt back into the deductibility fold as the new law undergoes technical corrections. Others are exploring ways which state and institutional loan programs can become mortgage backed debt.

and the curtailment of others will diminish many of these gains. Families in higher income brackets will lose the benefits of many traditional methods of sheltering income. High-income taxpayers may also be subject to an alternative minimum tax ("AMT"). (See explanatory box.) Many items deductible from regular income must be added back as "tax preference" items in the calculation of the AMT. The AMT is calculated at a flat rate of 21%. A taxpayer must pay the AMT if the AMT liability exceeds regular tax liability.

Independent students, most of whom will be in the lower tax bracket and are almost always without tax shelters, should keep more income after taxes under the 1986 law. The situation is different for dependent students. Under the old law both students and parents, provided certains support conditions were met, could deduct the personal exemption allowance of the student on their respective returns. Now, although the value of the personal exemption is rising, it may be taken on only one return. As a consequence, if a dependent student earns over $4,000, and the parents can claim her as a dependent, she is likely to pay more taxes under the new law.

The effects of changing after-tax family income are clearly mixed. However, to the extent that the act achieves its avowed goals of revenue neutrality and of shifting the tax incidence away from individuals to corporations, the average family should have more after-tax income with which to pay college bills.

Savings. Traditionally, many upper-middle-income families have saved for higher education by shifting savings into the name of their children under the Uniform Gift to Minors Act or by putting funds in educational (short-term grantor) trusts. The new code expands the taxpayer's income base by making the family a single taxpaying unit. Until the age of 14, a child's unearned income will be taxed in part at the child's parents rate. The new rules on personal deductions vary for earned and unearned income but the general result is that children's unearned income in excess of $1000 will be taxed at the parents' rate. Furthermore, the income generated by short-term grantor trusts will be taxed at the grantors' rate. Parents may still use a 2503(c) trust to transfer income to a minor child and pay taxes at the trust's rate rather than their own. Under this section, however, the funds must revert to the control of the child at age 21. At this time the child may leave the funds in the trust or may withdraw them and may (or may not) use them for educational purposes.

Parents who want to save for education and pay the least tax possible might consider transferring the money to the children and investing in long term securities (e.g., stock with low dividends but high potential appreciation) which can also be sold after the minor turns 14. They would then be taxed but at the lower rate, presumably 15 percent. While the appreciation of zero-coupon bonds is taxed as if it produced an annual yield, Series EE U.S. Savings Bonds, which sell at a deep discount, are not taxed this way. In effect, these Savings Bonds can be used to delay unearned income until the child is 14 or older. However, parents are limited to a $15,000 ($30,000 face value) annual investment per child in these bonds. Another strategy is to buy single premium life insurance from which the parent can borrow out the earnings and in some policies, a large portion of the principal at a low interest rate. No taxes are due unless the policy is surrendered. While this sounds attractive, it is not a very flexible form of savings and there are risks. There are often high surrender fees in the policy's early years. Moreover, the growth in the policy value is dependent on the success of the companies money managers. When cautioning families on this technique, one financial advisor quoted in a recent *Wall Street Journal* article observed: "Tax reform didn't turn these people into good money managers overnight."

Finally, for most taxpayers long term capital gains will be taxed at 28% instead of 20% as under the old law. As a consequence, families who sell appreciated assets to finance education will need a larger pool of assets after tax reform than before.

Loans. One of the most important deductions which has been eliminated is consumer interest expense. It may no longer be used to reduce adjustable gross income. Interest on mortgages on both first and second homes and certain interest on debt which is linked to investment income may still be used to reduce taxable income. The nondeductibility of consumer interest will be phased-in over five years. There are additional restrictions on deductible mortgage interest. Interest is only deductible on loans made up to the cost of initial purchase plus improvements. Interests on loans made on the appreciation of the property is not deductible. (Note: Rollover gains from previous homes are not included as part of the cost bases.) A beneficial exception for higher education is that individuals may borrow on the appreciation of their home up to its fair market value and retain the deduction of the interest expense if the funds from such loans are used for educational or medical purposes.

The obvious implication of these changes is that unless higher education debt is mortgage-based, the cost to students and their parents will rise dramatically. This issue is being challenged in two ways. Some higher education officials are trying to reintroduce all educational debt back into the deductibility fold as the new law undergoes technical corrections. Others are exploring ways which state and institutional loan programs can become mortgage-backed debt. The Massachusetts Educational Loan Authority, for example, just an-

Conference

The Forum for College Financing Alternatives held a symposium, New Ideas in Capital Finance—After Tax Reform, in mid-October in Annapolis, Maryland. About sixty very knowledgeable individuals in higher education finance were invited to attend. Eight speakers and numerous panelists presented issues ranging from debt financing mechanisms to for-profit subsidiaries. In addition to institutions, states, and educational associations, a number of attorneys, accountants and investment bankers participated. Among the firms represented were: Cambridge Associates, Coopers & Lybrand, Dillon Read, Dow Lohnes & Albertson, Eden Hannon, Goldman Sachs, L.F. Rothschild, Unterberg, Towbin, Morgan Guarantee Trust, Sallie Mae, and TIAA/CREF.

The major focus of the conference was the impact of tax reform on higher education. Many points raised by the participants are included in this issue of Capital Ideas. Future issues will describe in more depth other aspects of these thoughtful discussions.

nounced such a plan. The Forum will keep you informed of progress in both areas.

Financial Aid. Students will face changes in the tax treatment of their financial aid. While aid for tuition and fees will remain tax-free, scholarships and fellowships which require services or include stipends in excess of the costs of tuition and fees will be included in the student's gross income. As noted in the Family Income section above, a student can only claim the personal exemption if he cannot be claimed on the tax returns of his parents. As a consequence, the tax paid by many dependent students will rise. Paying tax on any student aid "income" will decrease the value of that aid. The effect of this additional tax on most independent students will not be too severe when considered within the context of the new lower rates, the increased personal exemptions and increased standard deduction. The effect of this on institutional record keeping may not be so minimal—an issue discussed below.

Another hidden consequence of the loss of the double claim on personal exemptions will be that students will have considerably less incentive to remain "dependent." Most tests of financial independence look to see if the parents claimed the prospective financial aid recipient as a dependent. The tax savings to parents of the dependency claim will be about half as great after tax reform. This reduction occurs in spite of the fact that the size of the personal deduction will double. As a consequence we may see surge of students claiming independent status. However, if parents can claim the student as a dependent and do not, the student is still precluded from claiming the personal exemption.

Summary. The Tax Reform Act of 1986 will affect the tuition area of college and university revenues in many ways. The lower tax rate and large personal exemptions should increase the ability of lower income families to contribute to the education of their children. These families also rarely use the many tax shelters which have been eliminated. Working students, however, may pay higher income taxes as they can no longer claim the personal exemption if they are listed as dependents on their parents' return. This change may lead to more students claiming independent status.

The loss of tax shelters and, specifically, the curtailment of income shifting techniques may diminish the ability of upper-middle-income families to pay for higher education. Although the children of these families will almost certainly still attend college, some may choose less costly institutions.

CHARITABLE CONTRIBUTIONS

Tax reform will have a substantial impact on the cost of giving at both the individual and corporate level. The changes in the treatment of charitable giving will mandate a reevaluation by colleges and universities of their strategies for fundraising.

Individuals. The reduction in tax rates reduces the value of a contribution by the difference between the old marginal tax rate, and the new—a nominal difference of 22 percentage points for some individuals. The "phase-out surtax" which increases the new marginal tax rate to 33 percent for many upper-middle-income tax payers results in a 9-16 percentage point reduction in the value of a charitable contribution. The new law also eliminates charitable deductions for non-itemizers so that individuals whose itemized deductions do not exceed the standard deduction achieve no tax benefit by their contribution.

The AMT combined with the new lower rates has a mixed effect on the incentive of individuals to give. The new law reduces the benefit of donating appreciated property to individuals subject to the AMT. Previously, individuals could donate appreciated property and deduct its full value from

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For those taxpayers not subject to the AMT, the incentive for giving appreciated property under the new law will decline only moderately.

their adjusted gross income. In this way they reduced their taxable income and concurrently avoided paying capital gains tax on the appreciation. Now, a taxpayer can deduct the market value of the appreciated property to calculate adjusted gross income but must add back that the appreciation (fair market value less basis, i.e., cost) in calculating tax liability for the AMT. Contributors of highly appreciated gifts with very high incomes who are subject to the AMT will have considerably less incentive to give as much in the future.

As of January 1, 1987 capital gains will no longer receive preferential treatment and will generally be taxed at a higher rate than in the past. The profit generated by the sale of an asset, regardless of how long it was held, will be taxed at the taxpayer's regular rate or 28 percent, whichever is less. As a consequence, for those taxpayers not subject to the AMT, the incentive for giving appreciated property under the new law will decline only moderately. And, with the elimination of capital gains as a tax preference item, some taxpayers will no longer be subject to the AMT.

In the case of a bargain sale, the donor allocates the gain between the sale portion and the gift portion. Part of the appreciation is attributed to the sale and is considered income. Part is attributed to the gift and is considered a preference.

If a contributor exceeds the deductibility ceiling in a given year only that portion of the appreciation allocated to the gift is subject to the AMT. The remaining portion of the appreciation and the remaining portion of the gift is carried forward to future years. The income ceiling for gifts of appreciated property to charitable organizations is 30%.

Because the exemption amounts are fairly high taxpayers with only a few preference items may not be subject to the AMT. However, if the taxpayers' income is very high or they have many preference items or they have few preference items but

Alternative Minimum Tax

The purpose of the Alternative Minimum Tax (AMT) is to reclaim some of the deductions that have allowed high-income taxpayers to substantially reduce their tax liability and sometimes to avoid paying taxes altogether. The structure of the AMT is not changed by the new law. Rather, the law changes the definitions of some tax preference items, adding some and eliminating others.

The change with the greatest impact on charitable giving for higher education is the inclusion of the appreciated property charitable deduction as a tax preference item. Since the dividend exclusion and preferential treatment for capital gains are repealed they will no longer be tax preference items.

In calculating AMT liability each taxpayer is entitled to an exemption. This exemption is phased out for high-income taxpayers at a rate of 25 cents per dollar for each dollar of minimum taxable income when that income exceeds certain levels. If the taxpayer's income is below these levels a calculation for the adjustment of the exemption need not be made because no exemption is lost. Above certain levels no calculation need be made because the entire exemption is eliminated.

To calculate the AMT begin with the taxpayers Adjusted Gross Income (AGI), reduce AGI by AMT deductions, add-back AMT preferences items, and reduce this amount by the taxpayer's AMT exemption. This amount equals the amount subject to the 21% tax rate.

Caclucation of AMT:	Adjusted Gross Income
less	AMT deductions
plus	AMT preferences
less	AMT exemption
times	21% AMT rate
equals	AMT liability

Type of Return	Initial Exemption Amount	Exemption Phase-out Begins	Exemption Eliminated Above
Single	$30,000	$112,500	$232,500
Joint Return	$40,000	$150,000	310,000
Married Filing Separately	$20,000	$ 75,000	$155,000

those items are quite large their AMT liability may exceed their regular tax liability.

Corporations. Many corporations will have lower marginal tax rates and therefore less incentive to give. The reduction could be as much as 12 percentage points, though for most corporations it will be 7 percentage points. Congress, however, has eliminated or curtailed many of the deductions and credits which businesses have used to reduce income and has mandated changes in accounting methods. As a consequence many corporations will have more of their income subject to taxation which could increase their incentive to give.

Corporations may also be subject to a corporate alternative minimum tax. The changes introduced by the new law include the redefinition and addition of tax preference items. It also requires that companies use book income to determine a tax preference. The alternative tax is imposed on AMT income at a rate of 20% with an exemption of $40,000. This exemption is phased out at a rate of 25 cents per dollar on AMT income above $150,000.

The new code changes tax treatment for expenditures incurred to increase research activities. Credit for such expenditures is in two parts: The Research and Experimentation Credit (R&E Credit) and the University Basic Research Credit (UBR Credit).

The R&E Credit provides for a 20% tax credit for research expenditures above a minimum level. The credit is intended to spur corporations to engage in scientific research. The expenditures need not, but may be, at a college or university. Previously the R&E Credit was 25% and was scheduled to end at the close of 1985. It has been extended retroactively through 1988 at the reduced rate. The new code narrows the definition of qualified research and experimentation. Qualified R&E is still limited to the physical and biological sciences. Now, however, it must be technological in nature, it must be experimental (involve the evaluation of more than one alternative), and it must be functional (useful in the development of a new or improved product, process, formula, etc.). It cannot involve the production of a particular product or begin after the onset of the production of a product. The credit equals 20% of the qualified expenses less a floor amount. As this credit is intended to spur *further* research it is incremental in that the floor amount is the average of research expenditures for the preceding three years. This credit is subject to the general business credit limitation as amended by the bill.

The UBR Credit changes tax treatment of expenditures by corporations for basic research at universities and other scientific institutions. Previously, corporations could include 65% of their expenditures for basic research in the calculation of their R&E Credit. The UBR Credit allows the corporation to include 100% of cash expenditures for basic research in the calculation of that credit. To qualify for inclusion in the UBR Credit expenditures must be made to a qualified organization, be made in cash, and must be paid under a written agreement. As with the R&E Credit, the UBR Credit is 20% of the qualified expenses less a base period amount. For the UBR Credit the base period amount is generally the sum of 1.) the average qualified university basic research expenditures from 1981 to 1983 and 2.) a maintenance-of-effort amount. The maintenance-of-effort amount is an amount reflecting any decrease in non-research giving to universities. This provision is intended to prevent shifts in corporate giving to research to take advantage of the new credit. However, there are two beneficial aspects of the UBR Credit. First, the base period amount is stable and does not increase over time as is the case with the R&E Credit. Second, those basic expenditures which are covered by the base period amount may be included in the calculation of the R&E Credit as contract research expenses.

In addition, the new law actually improves certain aspects of the tax effects of the charitable contribution of scientific equipment. As before the deduction for such a contribution is equal to the donor's cost plus half the appreciation. But the new code includes changes which will increase inventory values for businesses making such contributions more valuable. Finally, a special rule provides an augmented charitable deduction to corporations which donate newly manufactured scientific equipment to a college or university for research use in the physical or biological sciences.

Summary. Colleges and universities will probably find it more difficult to solicit contributions under the new law. The lower tax rates, the inclusion of the appreciated value of unrealized capital gains in calculating the AMT, and the non-deductibility of gifts for non-itemizers are the most serious changes. Colleges and particularly universities should look to corporations for potentially more contributions of equipment and for research contracts. If an institution has a current working relationship with one or more corporations, institutional officials should consider how the tax law will affect the tax situation of those companies.

Estate and Gift taxes are relatively unchanged by the new code. In particular the deductibility of charitable gifts is unlimited. With the concurrent changes in other areas, estates become a more valuable area for potential contributions. These changes create an opportunity for increased testamentary giving, an opportunity which deserves renewed attention by colleges and universities.

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Comparison of N

Issue	Old Law	New Law	Implications
INDIVIDUAL INCOME TAXES			
Individual Tax Rates	14-15 rate brackets from 11% to 50% indexed	5 rates in 1987, 38.5% top rate. 2 rates in 1988, indexed, 15% and 28% with 5% surcharge in certain ranges.	Loss of tax shelters will more than offset the gains from lower rates for many taxpayers.
Exemption	$1,080, indexed	$1,900 in 1987, $1,950 in 1988, $2,000 in 1989, indexed. Claimable on only one return. Phased-out for high income taxpayers.	Greater disposable income for non-itemizers. Dependent students may pay more tax. More students may claim independent status.
Standard Deductions		**1987** **1988**	Greater disposable income.
Single	$2,480, indexed	$2,540 $3,000 indexed	
Joint	$3,670, indexed	$3,760 $5,000 indexed	
Heads of Households	$2,540, indexed	$2,540 $4,400 indexed	
Minimum Tax on Individuals	Yes, 20% rate	21% rate; new preference items include appreciation on contributed property and tax-exempt interest on certain newly issued private activity bonds (exception for 501(c)(3) bonds).	Increased numbers of tax preference items will mean more high-income individuals will be subject to AMT. They will pay more tax than if they were taxed at regular rates on adjusted gross income. Reduced incentive to give appreciated property.
BUSINESS INCOME TAXES			
Corporate Tax Rate	Graduated, up to 46%	(1988) $0-50,000 15% 50,000-75,000 25% over 75,000 34%	Reduce value of charitable contributions.
Minimum Corporate Tax	Add-on tax is 15%	20% alternative tax with additional preferences.	Elimination of many deductions will increase income subject to taxation for many businesses and increase the value of charitable contributions.
ITEMIZED DEDUCTIONS			
Mortgage Interest	Deductible	Deductible for principal and second residence; limit to home cost plus improvements plus medical and educational expenses.	Tendency for borrowers and lenders to utilize equity built up in home for consumer purposes.
Other Personal Interest	Deductible	Consumer interest not deductible, 4-year phase-out. Investment interest generally deductible to extent of investment income.	Increases the cost of non-mortgage backed loans so loans will be much less attractive.
Charitable Contributions and Moving Expenses	Deductible for itemizers and non-itemizers	Deductible for itemizers; no deduction for non-itemizers after 1986.	Lower tax rates reduce the incentive to make charitable contributions.
Income Shifting to Children	Permitted	Heavily curtailed.	This popular means of saving for higher education is greatly reduced for those shifting significant asets. 2503(c) trusts still available.
LONG-TERM CAPITAL GAINS			
Individuals	60% deduction; 20% maximum rate	Deduction repealed, 28% maximum rate.	Disincentive to parents to sell stocks etc. to pay tuition bills. Reduce the value of holding investments for long periods and increases short-term profit taking.
Corporations	28% maximum rate	34% maximum rate in 1987 and thereafter; no preferential capital gain rate.	

w Law to Old Law

Issue	Old Law	New Law	Implications
TRUSTS AND ESTATES			
Nongrantor Trusts	Nongrantor trusts taxed separately at married filing separate rates.	Nongrantor trusts and estates taxed at new rates, both would be required to make estimated payments.	Tax rates for trusts and estates remain quite high reducing the effectiveness of the use of such trusts as a savings vehicle.
Reversionary Trusts	Greater than 10 years not taxed to grantor.	Taxable to grantor.	Significantly reduces the use of these trusts.
Accounting Periods for Trusts	Adopt any tax year.	Trusts other than charitable and tax-exempt trusts must adopt/change to a calendar year.	Increased administrative costs.
CREDITS			
Research and Experimentation Credit	25% Credit.	Extended retroactively. 20% credit with new restrictions.	Still a valuable credit for higher education with modest new restrictions.
University Basic Research Credit	65% of allowable expenses included. Ever increasing base amount.	100% of allowable expenses included. Stable base amount.	Increased incentive to finance basic research.
TAX-EXEMPT DEBT			
Deduction for financial institutions for interest to carry tax-exempt issues.	Yes.	No deduction allowed on bonds acquired after August 7, 1986 in tax years after 1986.	Increases costs to institutions investing in tax-exempt bonds.
Municiple Bonds	No limit on issuance costs; limited volume caps.	Limit on allowable issuance costs; volume limitation reduced and expanded; new arbitrage and refunding restrictions.	New restrictions change the structure of the costs associated with floating a tax-exempt bond issue.
Private Activity.	Some restrictions. 501(c)(3) organizations are not considered private use.	Increased restrictions. 501(c)(3) organizations considered private use but exempt from unified volume cap.	More difficult to finance "mixed-use" facilities.
Institutional Cap.	None.	$150 million for private institutions.	Shuts the largest 30 private universities out of the tax-exempt market.
Arbitrage Income.	Modest limitations.	Strict limitations.	Arbitrage income is essentially eliminated increasing costs of tax-exempt debt.
RETIREMENT SAVINGS			
Individual Retirement Accounts.	$2,000 deduction, $250 spousal, tax deferred accumulation.	IRA deduction phased out for middle- and high-earning plan participants; continued tax-deferred accumulation on non-deductible IRA's.	Less family savings locked up in IRA's and more available for higher education.
401(k) Plans.	Tax deferred under qualified plans, subject to $30,000 limitation.	Elective deferral limited to $7,000 annually.	Some higher education employees will have higher tax liability.
403(b) Tax-sheltered Annuity.	No nondiscrimination requirement or withdrawal restrictions.	Imposes $9,500 limit on elective deferrals, nondiscrimination and withdrawal requirements.	Some higher education employees will have higher tax liability.
Retirement Distributions.	10% penalty on distributions before 59½ to 5% owners and from IRA's.	10% penalty on distribution before 59½ with certain exception.	Will somewhat mute the effects of the elimination of mandatory retirement provisions.
Vesting.	Full vesting required after 10 years or graded vesting schedule.	Full vesting after 5 years or 7 years under accelerated graded vesting schedule.	Increased pension costs.

Under the new law it is even more critical that investment bankers and bond counsel be brought into the capital planning process early.

Worrisome also is that now that independent colleges and universities are included in the "private use" category it will be more complicated to structure debt which serves both sectors. As a result some new cooperative ventures between the two sectors may never get off the ground.

DEBT FINANCING

The debt issues of state and local subdivisions are generally labeled governmental use bonds or private activity bonds depending upon the purpose for which the funds are raised. Funds raised to build a courthouse or buy police cars are obviously for "governmental use." Funds used to provide low interest debt to private re-developers of a city slum would be "private activity." Student Loan bonds were previously, and continue to be, categorized as private activity bonds. Unfortunately for private higher education, the debt of educational, scientific, charitable and religious organizations, that is 501(c)(3) organizations, will now be considered private activity debt.

To distinguish between "governmental use" and "private activity" bonds, the IRS uses several tests which relate to who will use or benefit from the proceeds of the debt and how the debt is secured. The percentage of the debt allowed to be used by or secured by private interest has been reduced. Under the old law, governmental use bonds could use 25 percent private collateral. Now that limit has been lowered to 10 percent. The tests are even more restrictive for 501(c)(3) organizations which, to maintain tax-exempt status, must meet a 5 percent standard. Student loan bonds receive special treatment and will be held to the 10 percent level. These more restrictive tests create obvious, although complicated, problems. For example, if tax-exempt debt is used to build a research facility which will house cooperative research with industry, the tax-exempt status of the entire debt issue may be jeopardized. Or, the construction of dormitories which include private franchises may be ineligible for tax-exempt financing. The lesson is that under the new law it is even more critical that investment bankers and bond counsel be brought into the capital planning process early.

The new law places stricter limits on the amount of outstanding private-activity debt a state may issue each calendar year. This unified volume cap will be the great of $75 per resident or $250 million until December 31, 1987. Thereafter it will be the greater of $50 per resident or $150 million. This cap includes qualified student loan bonds. Fortunately for colleges and universities, qualified 501(c)(3) bonds are specifically exempt from the unified volume cap.

Except for hospitals, all 501(c)(3) institutions are individually limited to $150 million of outstanding tax-exempt bonds. As a result approximately 30 of the largest private universities will be effectively shut out of the tax-exempt bond market from now on. Issuing taxable debt is an alternative and has the advantage of being considerably more flexible but institutions will pay an additional two or more percentage points on such debt. Moreover, unless the law is changed more and more private colleges will find themselves bumping up against the $150 million ceiling.

Both governmental use and private activity bonds are subject to a 2 percent cap on the cost of issuance. The purpose of this regulation, presumably, is to control costs. It is hard to imagine that it will be effective as the investment banking business will undoubtedly unbundle their services and charge separately for activities that were previously included in the cost of issuance.

Worrisome also is that now that independent colleges and universities are included in the "private use" category it will be more complicated to structure debt which serves both sectors. As a result some new cooperative ventures between the two sectors may never get off the ground.

Finally, in an effort to control the use of tax-exempt debt to produce extra income new "arbitrage" restrictions have been enacted. Issuers of tax-exempt debt generally do not need the full proceeds of the debt immediately. In addition, lenders often require that a reserve fund be established to help ensure repayment of the debt. The unused portion of the debt and the reserve fund can be invested. Because the issuers are tax-exempt, the interest they earn from taxable securities will almost always exceed the interest they pay. In the tax-exempt bond world this difference is called arbitrage. For all issuers the opportunities for arbitrage earnings have been essentially eliminated. The loss of arbitrage income will raise the costs of every activity financed with tax-exempt debt.

Summary. A major effect of the new law will be the further limitations placed on the private use of capital assets financed with tax-exempt debt. State and institutional planners must keep these restrictions in mind as they plan capital projects. The limitations on arbitrage income will increase the cost of using tax-exempt debt for all institutions. But the situation is much more serious for the largest private universities. They will, in effect, be excluded from tax-exempt debt markets unless the $150 million cap is removed.

ENDOWMENT INCOME

There are a few changes in the new law which affect endowment income. The law more rigidly defines reporting requirements for non-profit organizations and establishes new penalties for reporting violations. In addition there are rumblings from several corners that perhaps endowment income should be taxable. While these rumblings are not very loud they are frightening in their implications for the future of higher education finance. Specifically, such a tax would immediately increase costs by diverting funds away from endowment income from institutional use to payment of tax liability.

GOVERNMENTAL APPROPRIATION

Tax reform does not specifically impact federal

appropriations for colleges and universities. However, the tightening of the federal budget relating to social service expenditures, particularly higher education, and the predisposition of the federal govenment to move away from grants and federally subsidized programs indicate that a cooler climate for federal appropriations will continue for some time.

At the state level there is some reason for optimism. The rationale of federal tax reform was the lowering of tax rates with the simultaneous elimination of loopholes. The expectation is that the revenue raised will be essentially the same. Most states base their income tax on the federal model but set their rates independently. As a consequence of federal tax reform—the elimination of deductions and credits—many states face the prospect of a windfall revenue gain unless they lower their tax rates as the federal government did. State legislators are expected to take a middle position, lowering rates somewhat but not enough to completely offset the revenue gain. Higher education, particularly state-supported colleges and universities, should receive a share of these new revenues.

States whose primary source of revenue is derived from a state sales tax are in a different position. The elimination of the deductibility of sales tax from federal tax returns may increase pressure for such states to reduce their sales tax rates or to switch to an income tax based revenue system. Institutions which receive funds from sales tax generated revenues will face increasing competition for funds if states retain their tax structure but reduce their tax rates because the same players will be fighting for larger parts of a smaller pie.

Expenditures

Institutional expenditures fall into a broad range of categories. In many of these categories the effect of the 1986 code will be increased costs. Changes in the rules effecting retirement benefits, increased expenditures for student aid to compensate for aid lost to taxation, and the costs of appraising the value of faculty housing are just a few examples of such increases. Institutional benefits and compliance costs are discussed below.

RETIREMENT BENEFITS

The greatest change wrought by tax reform on the expenditure side is in the area of employee relationships specifically in retirement benefits. Under the new law colleges and universities with unfunded deferred compensation plans will be subject to the same restrictions which now apply to state and local governments. These rules are far less liberal than the old rules.

Unfunded deferred compensation arrangements and 403(b) tax-sheltered annuity arrangements will be subject to new restrictions and dollar limitations. Beginning in 1989, the maximum for contributions to unfunded deferred compensation arrangements will be the lesser of $7,500 or a third of the individual's compensation. However the new restrictions do not apply to previously established plans which call for fixed annual deferrals. New minimum distribution rules will also take effect. Generally these rules require that distributions begin when the beneficiary of the plan reaches 70½. After 1986 the act imposes a penalty tax of 10% on premature distributions from qualified funded plans. Generally such a distribution occurs if it is made before the beneficiary reaches 59½.

401(k) plans established prior to July 2, 1986 are allowable under a grandfather clause but contributions to other tax-sheltered annuity or unfunded deferred compensation arrangements will be reduced by the amount contributed to a 401(k) plan. The maximum amount an employee can elect to defer will be reduced from $30,000 to $7,000. The $7,000 limitation will be adjusted for inflation.

After 1986, employee contributions to tax-sheltered annuities are limited to $9,500 annually. When the $7,000 contribution limit for 401(k)s as adjusted for inflation reaches $9,500 the limitation for tax-sheltered annuities will be adjusted for inflation.

The new law extends nondiscrimination rules to tax-sheltered annuities. These rules require that payments not made pursuant to a salary reduction agreement cannot discriminate in coverage or benefits in favor of highly compensated employees. Highly compensated employees are defined as those:

1.) receiving compensation of more than $75,000 a year,

2.) earning more than $50,000 and in the top 20% of employees to pay that year, or

3.) earning more than $45,000 and an officer of the employer.

An institution cannot have less than three officers. It may consider 10% of its employees officers up to a limit of 50.

There are some employees who may be excluded for the purposes of the eligibility test. These include employees 1.) who are covered by a collective bargaining agreement, 2.) who work less than 17½ hours a week, and 3.) those under age 21, among others. Also, unless the salary reduction program is available to all employees of the institution the act will consider it discriminatory.

Colleges and universities with unfunded deferred compensation plans will be subject to the same restrictions which now apply to state and local governments.

Tuition Plan Progress

Governor Blanchard signed the Michigan Educational Trust Law on December 23, 1986 making it the first state to have a tuition pre-purchase plan signed into law. Although the Michigan Senate and the House reshaped the original law somewhat, the basic concept remains intact. There are some pricing changes regarding attendance at community college and at the most expensive public institutions. The new law also allows participants who decide to attend a private institution to withdraw from the plan with essentially no penalty. The Senate has, quite reasonably, insisted that the final plan be financially sound and pass muster with the Internal Revenue Service. Attorneys in Michigan have recently prepared a request for a "letter ruling."

Dozens of other states have initiated legislation or a planning process for such a plan. The Forum has worked with some of them. **If your state has draft legislation or a report on the topic, the Forum would like to receive a copy.** Please send it to Dr. Richard E. Anderson, Box 38, Teachers College — Columbia University, New York, N.Y. 10027.

Rules effecting vesting requirements are changed. For participants in plans, for plan years beginning after 1988, the minimum requirement for full vesting is reduced from ten years to five. Plans which use graded vesting must provide a minimum of 20% vesting after three years of service and 20% each year thereafter. This would result in full vesting after seven years.

The law also alters rules regarding IRA's. IRA's generally will not be available to individuals or their spouses who are able to participate in an employer sponsored retirement plan. However any individual may make a non-deductible contribution to an IRA the earnings of which will be tax-exempt until withdrawal. In addition a 10 percent penalty tax as well as tax as regular income will apply for early withdrawals.

OTHER EMPLOYEE BENEFITS

The new law clarifies current questions relating to the taxability of qualified campus lodging. For all taxable years beginning on or after January 1, 1986 qualified campus lodging, i.e., housing provided by an institution to its employees, will not be taxable as regular income if certain conditions are met. These conditions are 1.) the housing must be on or near campus, and 2.) the employees must pay rent, which equals or exceeds 5% on an annualized basis, of the housing's fair market value. This value must be appraised independently. If these conditions are not satisfied then the fair rental value must be included as income for tax purposes.

The act increases the cap on excludable educational assistance benefits from $5,000 to $5,250. The new law extends this exclusion retroactive to January 1, 1986 for two years through December 31, 1987.

COMPLIANCE COSTS

The extra data gathering and information reporting required by the new law is likely to increase the burden of compliance in terms of administrative time and expense for colleges and universities. In addition to the areas mentioned above, some of the more significant burdens are as follows:

- Institutions will incur costs to evaluate charitable gifts and examine their acceptance criteria.
- Institutions must review and change benefit programs and disseminate information about those changes to their employees.
- Unrelated business income estimates must be made and paid quarterly.
- The new law requires that all tax-exempt interest received must be shown on tax returns and thus this interest must be reported by issuers.
- Universities will have to withhold tax at a rate of 14% on taxable scholarship amounts for international students with scholarships.

Summary. Colleges and universities will experience a substantial increase in record keeping related to a wide variety of institutional expenses as a result of the new law. Being aware of the ramifications of the changes may facilitate institutional transition towards compliance with the new law.

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Thirteen national authorities on higher education finance and management have agreed to serve as advisors to the Forum. They are:

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CAPITAL IDEAS

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